(29)

No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

REPLY BRIEF OF PETITIONERS

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REPLY BRIEF

Respondents read the heightened pleading provision of the Private Securities Litigation Reform Act ("Reform Act") to defeat itself. The Reform Act does not require facts merely giving rise to "an inference" or a capacious "reasonable inference." It expressly requires a "strong inference." Yet respondents not only propose a "reasonable inference" standard, Resp. Br. 24, they sap any potential vigor from even that standard by urging that plaintiff-friendly presumptions apply to motions to dismiss governed by the Reform Act. However well suited such presumptions are for the open-door policy of notice pleading, they find no support in the structure and purpose of the Reform Act. Whether worded in terms of a heightened "strength" requirement, or viewed as a narrowed range of "reasonableness," it is clear that Congress sought to ensure that claims based on weak inferences are dismissed.

Unlike respondents' approach, petitioners' standard—that a plaintiff must "plead specific facts that, if proven to be true, cogently demonstrate a substantial claim as to scienter that meaningfully tends to exclude innocent possibilities," Pet. Br. 16—gives content to the word "strong." As importantly, petitioners advocate three guiding principles that equip a court to police securities fraud complaints as Congress intended. First, the reference to whether "the complaint" alleges facts giving rise to a "strong inference" of scienter means that a court must take into consideration *all* the facts alleged and inferences to be drawn therefrom, including taking account of those that weaken any inference of scienter. Second, allegations that are ambiguous as to scienter, *i.e.*, allegations that merely suggest a possibility of scienter but which, by themselves, provide no more reason to believe that scienter was present than absent, cannot create a "strong inference" of scienter. Moreover, when a plaintiff strategically pleads critical facts ambiguously, those facts cannot create a strong inference. Third, the presence or

absence of any motive to engage in fraud also bears on the strength of any inference of scienter, with the absence of any evident motive necessitating that the other circumstantial evidence be that much stronger for a "strong inference" to exist. These principles reflect the core of this case. The Seventh Circuit's decision is fatally flawed because it fails meaningfully to apply any of them.

Moreover, even though the core of respondents' own interpretation of the "strong inference" standard is the reasonableness of the inference that Notebaert acted with fraudulent intent, respondents never describe the supposedly rational connection from the facts relied upon by the Seventh Circuit to the inferred conclusion. Indeed, respondents simply ignore the Seventh Circuit's effort to bridge the gap between the facts pled and Notebaert's scienter, opting instead for an empty assurance that the connection exists. Resp. Br. 25. Claiming that they are entitled to benefit from their own ambiguity, respondents offer a contentless "reasonableness" standard that is as flexible as the imagination of plaintiffs' counsel, and that ignores the congressional policy to deprive plaintiffs of access to costly and disruptive discovery when they allege only weak inferences of scienter.

The pleading principles advanced by petitioners provide the critical content to the "strong inference" standard that respondents' argument lacks. Applying these principles to the allegations of this complaint requires reversal and will provide strong guidance to lower courts that frequently face complaints relying on similar allegations.

1. Respondents begin with an attempt to place the Reform Act's pleading requirements within the rubric of traditional standards and presumptions applicable to motions to dismiss. Even after the Reform Act, respondents argue, plaintiffs still "need not plead detailed evidence" and "the allegations of the complaint should be construed favorably to the pleader." Resp. Br. 17.

It is hard to imagine what more Congress might say in the Reform Act to make it clear that a departure from such traditional rules is required. To begin with, the entire purpose of the relevant Reform Act provision is to ensure that a plaintiff pleads at this initial stage detailed, *i.e.*, "particular[ized]," facts giving rise to a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). And it is precisely because Congress intended an early evaluation of the adequacy of the asserted factual basis for a claim of scienter that the Reform Act affirmatively forbids recourse to discovery unless the facts demonstrate a "strong inference" at the outset. *Id.* § 78u-4(b)(3)(B). Moreover, not only did Congress expressly require "particularity," it required that when a plaintiff alleges on information and belief that a statement is misleading, the plaintiff must "state with particularity *all* facts on which that belief is formed." *Id.* § 78u-4(b)(1) (emphasis added). These significant and detailed changes were "enacted as an exception, not just to state an already existing rule." *Stone* v. *INS*, 514 U.S. 386, 397 (1995).

Likewise, the general rule requiring courts to construe the allegations of a complaint entirely in favor of the plaintiff must be modified if the requirement that "the complaint" support a "strong inference" of scienter is to have any meaning. If everything is to be construed favorably to plaintiff, regardless how strong or weak the inference, then the "strong inference" standard is nothing more than a requirement to allege facts that give rise to a bare possibility of scienter. *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002); *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003). But Congress passed the Reform Act to put an end to weakly-grounded securities fraud suits. Pet. Br. 26-31. Indeed, it is precisely because Congress wished to alter the loose and forgiving approach to a plaintiff's pleading of scienter that the "strong inference" requirement was adopted. *Id.* at 29. It makes no sense to interpret a statute that requires a plaintiff to plead facts giving rise to a "strong inference" of

scienter as nonetheless allowing a complaint to survive based on nothing more than indulgent constructions of allegations which presume that discovery may yield evidence to support a weak claim.

Yet that is precisely what respondents advocate, arguing, for example, that pleading ambiguities should give rise to plaintiff-favorable inferences. Resp. Br. 33-35. Nor does it advance the inquiry to say that only "reasonable inferences" should be construed in a plaintiff's favor. This merely shifts the problem to a different level. In fact, what is "reasonable" in this context is itself a function of the "strong inference" requirement. *Infra* at 15-17. And that is why most courts applying the Reform Act have refused to credit certain common weak inferences, *e.g.*, that because of his or her position, a defendant "must have known" what was occurring throughout the company. Pet. Br. 40.

2. Despite their assertions that the Reform Act does not alter the mode of analysis applicable to a motion to dismiss, respondents ultimately articulate a proposed standard that is clearly more demanding than that generally applied to a Rule 12(b)(6) motion. Respondents ask this Court to hold that "[a]n inference [is] 'strong' if the particularized allegations support a reasonable conclusion that the defendant *probably*—i.e., *more likely than not*—had scienter." Resp. Br. 24 (emphases added). Respondents assert that a textual parsing of the "strong inference" standard "connotes probability and tendency." *Id.* at 25.

At this level of abstraction, there might appear to be less distance between respondents' and petitioners' standards than respondents' heated rhetoric would suggest. Like respondents, petitioners propose a standard that speaks in terms of probabilities and tendencies. A plaintiff must "plead specific facts that, if proven to be true, cogently demonstrate a substantial claim as to scienter that meaningfully *tends* to exclude innocent possibilities." Pet. Br. 16 (emphasis added). And a fact does not "tend to exclude" innocence if it is

equally consistent with innocence and culpability, *i.e.*, if there is no "probability." *Id.* at. 37-41.

Notwithstanding their verbal similarity, respondents and petitioners fundamentally diverge with respect to how these standards work. Respondents take issue with each of the three guiding principles petitioners advanced. See *id.* at 33-41. The heart of the dispute between the parties resides at this level, including how these principles should be applied to the facts alleged, which also goes to the core of the Seventh Circuit's error in this case.

a. Though respondents advocate requiring a court to evaluate whether it is reasonable to conclude that the facts in the complaint show that it is more likely than not that a defendant acted with scienter, they offer a one-sided method that leaves a court unable to deny that an available inference of scienter is anything but strong. Respondents would constrain a court to consider only the inferences of scienter that favor the plaintiff. They would thus have the court shut its eyes to any inferences that weaken the inference of scienter, even to innocent possibilities that are evident on the face of the complaint. See Resp. Br. 18. By divorcing the plaintiff-favorable inference from its context, and excluding any consideration of negative inferences, respondents seek to create an inappropriate and artificial "vacuum" in which an objective evaluation of the strength of an inference cannot take place. *Gompper*, 298 F.3d at 896; *Pirraglia*, 339 F.3d at 1187; *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 51 (1st Cir. 2005).[1] Respondents' view contradicts the plain language of the Reform Act, which requires a court to review "the complaint" to determine whether the "strong inference" standard is met, not merely some parts of the complaint.

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[1] As discussed in petitioners' brief, the Seventh Circuit created just such a vacuum by reviewing the allegations before it only for inferences that supported scienter, divorcing them from the full context that weakened that inference. Pet. Br. 46-48.

Indeed, the outcome of respondents' "more likely than not" scienter test becomes foreordained because no defendant-favorable inferences can even be considered; once a court perceives *any* basis for concluding the defendant acted with scienter, the inquiry ends.

The appropriate test considers *all* the facts and inferences available from *all* the allegations and other material properly before the court. This inclusive approach flows from what both parties' standards share in common: a court's need to evaluate whether the record on a Rule 12(b)(6) motion, taking the allegations as true, would support a valid scienter finding. A "reasonable" conclusion that a defendant "probably" acted with scienter—respondents' stated test—is not one that ignores substantial countervailing facts and innocent explanations, or fails to take into account critical gaps. A "reasonable" conclusion is based on all the facts. *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 586-87 (1986). And when the available inferences are evaluated in light of the full record, the innocent inference may appear "at least equal to the [culpable] inference ..., thus negating the probative force" of the culpable inference. *First Nat'l Bank of Ariz.* v. *Cities Serv. Co.*, 391 U.S. 253, 280 (1968). In such a circumstance, no reasonable "probability" of scienter can be said to exist.

This is not to say that a complaint need rule out every *conceivable* innocent explanation to give rise to a "strong inference" of scienter. "Inferences must be reasonable and strong—but not irrefutable." *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (*en banc*). Neither do petitioners argue that a court should choose among competing "strong" inferences, and credit only the "strongest." The point is that consideration of innocent explanations and countervailing facts is part of the process of determining whether an inference of scienter is "strong" in the first place. Respondents concede as much when they endorse the Tenth Circuit's standard, which expressly states that a plaintiff must

"'plead[] facts with particularity that, *in the overall context of the pleadings, including potentially negative inferences,* give rise to a strong inference of scienter.'" Resp. Br. 29 (quoting *Pirraglia*, 339 F.3d at 1188 (emphasis added)). When the pleaded facts, taken as a whole, do not meaningfully tend to exclude innocent explanations, they do not demonstrate that culpability can reasonably be found to be more likely than not, and the inference of scienter is not "strong."

b. The treatment of ambiguous pleading is the second way that respondents' approach to the strong inference standard differs substantially from that of petitioners. Petitioners identified two different kinds of pleading ambiguities: (1) strategic ambiguity that leaves out details that would clarify whether conduct was innocent or culpable, and (2) allegations of conduct that are as consistent with innocence as culpability. Pet. Br. 38-41. Both kinds of ambiguous pleading fail to give rise to a "strong inference" of scienter because, in not distinguishing culpable from innocent conduct, they give the court (and a factfinder) no basis for concluding that the culpable conclusion is more probable.

Respondents assert that strategic ambiguity is a "fanciful" notion, and that there is no reason to require a complaint to provide "details that would clarify whether defendants' conduct was either innocent or culpable." Resp. Br. 33-34. They argue that any acknowledgment of innocent explanations that emerge from the ambiguity in a pleading would involve impermissible "judicial surmise ... without any factual record ... to show what information was left out[;]" they describe the process as "[s]peculation" based on "information that historically has not been considered on a motion to dismiss." *Id.* at 34-35.

These claims of impermissible speculation are precisely upside-down. A court evaluating whether ambiguities in a pleading render any inference of scienter too weak to satisfy the "strong inference" standard is not speculating regarding what other evidence may exist, nor is it considering any

information beyond that properly before it. The plaintiff, as master of the complaint, controls the degree of ambiguity in the pleading. And if the plaintiff fails to fill in critical, clarifying details, then the plaintiff has not pled "facts" sufficient for a "strong inference," or even with the requisite "particularity." Under these circumstances, it is the plaintiff that is requesting the benefit of mere speculation, and the inference of scienter is correspondingly weakened. While the facts alleged in the complaint must be taken as true, "[i]t is not ... proper to assume that [a plaintiff] can prove facts that it has not alleged." *Associated Gen. Contractors of Cal., Inc.* v. *California State Council of Carpenters*, 459 U.S. 519, 526 (1983).

The complaint in this case provides particularly dramatic examples. Respondents chose to include within their definition of "channel stuffing" lawful discounting to encourage sales. JA 110, ¶ 62. And while respondents alleged that Notebaert knew of "channel stuffing," they chose *not* to specify the precise conduct of which he was allegedly aware—*i.e.*, was it legitimate discounting or illegitimately sending unordered products to customers? JA 111, 157, ¶¶ 67, 156. The district court even pointed this ambiguity out to respondents when dismissing an earlier complaint without prejudice. Pet. App. 74a. Yet respondents *still* chose not to delete any reference to legitimate conduct from their "channel stuffing" allegation, and refused to provide any detail regarding which type of "channel stuffing" Notebaert allegedly participated in. Petitioners are not engaged in "self-serving speculation," Resp. Br. 12, when they point out that plaintiffs' own allegations are constructed in a way that is perfectly consistent with innocence.

Likewise, respondents assert that it is wrong to require clarifying detail such as the precise dates of reports because that is the kind of information that is likely unable to be known until they can take discovery. *Id.* at 35. But here the precise dates of reports are critical to distinguish legitimate

conduct from culpable conduct because the reports are the basis of the claim that Notebaert supposedly knew his statements were false when made. See Pet. App. 23a-24a. A complaint missing the critical facts connecting a defendant's false statement to his knowledge of its falsity does not give rise to a "strong inference" of scienter. Moreover, under the Reform Act, the argument that the plaintiff cannot plead a critical fact, but hopes to learn the truth through discovery, has no place; the Reform Act forecloses access to discovery until the plaintiff is able to demonstrate that the factual basis for a "strong inference" of scienter already exists. 15 U.S.C. § 78u-4(b)(3)(B).

Respondents, consistent with their claim to all plaintiff-friendly constructions, believe ambiguous pleading should not be disfavored. Resp. Br. 35 (arguing that ambiguity "should not deprive plaintiff of favorable inferences he or she would otherwise receive"). Ambiguity, under their endlessly malleable "reasonable inference" standard, comes without risk to plaintiffs because a court must treat that which is imprecise as if it were clear and favorable to the plaintiff's assertion of scienter.

But encouraging ambiguous pleading is the opposite of what the Reform Act was intended to accomplish. Ambiguous allegations produce precisely the kind of "weak" inference that the Reform Act sought to eliminate. By insisting on particularity in pleading and imposing a "strong inference" standard, the text of the Reform Act makes clear that Congress sought to increase the confidence a court has that it is allowing only cases with substantial merit to move forward into costly and burdensome discovery. A complaint that states critical facts ambiguously provides no such confidence.

Yet again, respondents ultimately run from their own position. Respondents concede that "when evidence indicates wrongful behavior and perfectly lawful behavior in equal measure, it is not on its own probative." Resp. Br. 37 n.38 (citing *Pennsylvania R.R.* v. *Chamberlain*, 288 U.S. 333, 339-

40 (1933)). That concession is fatal to the complaint. The channel stuffing allegations and the allegations of various reports regarding customer demand do not, absent critical clarifying details, point either toward or away from a conclusion that Notebaert acted with scienter. "One can tell the [culpable] instance from the wholly [innocent] one only by reference to some further circumstance." *Virginia* v. *Black*, 538 U.S. 343, 385 (2003) (Souter, J., concurring in part and dissenting in part). If, as here, the allegations fail to distinguish culpable from innocent conduct, what has been stated fails to give rise to a "strong inference" of scienter.

c. The third significant difference between respondents' and petitioners' approaches is the treatment of the presence or absence of allegations of motive. Respondents incorrectly claim that petitioners seek to require a plaintiff to plead adequate allegations of motive to give rise to a strong inference of scienter. Resp. Br. 36. In fact, petitioners merely argued that the presence or absence of plausible motive allegations impacts the strength of any inference of scienter. Pet. Br. 36-37. Motive is part of the full package of facts that, taken together, a court should evaluate. Thus, while its presence is not a *sine qua non*, its absence or implausibility is telling. This view has never been controversial. The Second Circuit, for example, has held that when a complaint fails to plead allegations of motive, the strength of other circumstantial allegations of scienter "must be correspondingly greater." *Kalnit* v. *Eichler*, 264 F.3d 131, 142 (2d Cir. 2001); see *Cities Serv.*, 391 U.S. at 287 (holding that an "inference of conspiracy sought to be drawn ... does not logically follow" in the absence of any motive for participation). That is all petitioners advocate.

3. Petitioners' approach to facts and inferences pointing away from scienter, ambiguous pleading, and the presence or absence of motive are all well rooted in a substantial body of caselaw. Respondents assert that petitioners' approach is "unprecedented," Resp. Br. 34, without discussing the cases

upon which petitioners relied. See Pet. Br. 35-40. Those cases belie respondents' argument that the courts have been and should be uncritically accepting of inferences claimed to be favorable to plaintiffs, even in the face of contrary inferences and ambiguity, and even when no allegations of motive are present. See, *e.g.*, *Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 26-27 (1st Cir. 1992) (Breyer, J.).

The prior decisions supporting petitioners' view include those of the Second Circuit, which respondents urge has provided the standard for what constitutes a "strong inference." In assessing whether a plaintiff has alleged facts that give rise to a strong inference of scienter, the Second Circuit considers the record as a whole, including inferences that undercut scienter. *E.g.*, *Rombach* v. *Chang*, 355 F.3d 164, 176 (2d Cir. 2004) (noting that "the allegation that defendants behaved recklessly is weakened by their disclosure of certain financial problems prior to the deadline to file [the company's] financial statements"); *San Leandro Emergency Med. Group Profit Sharing Plan* v. *Philip Morris Cos.*, 75 F.3d 801, 814 (2d Cir. 1996) (affirming dismissal even though one defendant sold stock because "the fact that other defendants did not sell their shares during the relevant period sufficiently undermines plaintiffs' claim"); *Acito* v. *IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) (same). Further, as noted above, the Second Circuit takes the presence or absence of motive into account. *Kalnit*, 264 F.3d at 142. The Second Circuit also disdains ambiguous pleading, refusing, for example, to draw a strong inference of scienter from ordinary conduct that is as consistent with innocence as with guilt, such as the desire to maintain the appearance of corporate profitability and the desire to maintain a high stock price in order to increase executive compensation or prolong the benefits of holding a corporate office. *E.g.*, *Novak* v. *Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000).

All of this renders academic respondents' claim that the legislative history demonstrates that Congress intended to

adopt what the Second Circuit had been doing. Even if that were Congress's intent, respondents' complaint would still fail for the reasons discussed in petitioners' opening brief. Still, that was not Congress's intent. Although Congress borrowed the phrase "strong inference" from the Second Circuit, Congress made clear that it did not "intend to codify the Second Circuit's case law interpreting this pleading standard." H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740; see also S. Rep. No. 104-98, at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694 (same); Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States, 141 Cong. Rec. H15214, H15215 (daily ed. Dec. 20, 1995) (noting that the conferees "make crystal clear" their intention to raise the pleading standard above prior Second Circuit law). Nothing in the subsequent legislative history from the Securities Litigation Uniform Standards Act of 1998 is inconsistent with the Reform Act legislative history. Congress merely reiterated that the "strong inference" standard was "based upon" the Second Circuit's standard. H.R. Conf. Rep. No. 105-803, at 15 (1998).

Finally, the fact that petitioners' operative principles are well rooted in prior decisions shows that respondents and their *amici* are engaged in unconstrained exaggeration when they suggest that petitioners' standard is near impossible to meet. Resp. Br. 23-24, 34-35. Numerous cases, including those within the Second Circuit, have allowed complaints to survive based on allegations that petitioners recognize satisfy the strong inference standard. *E.g.*, *Novak*, 216 F.3d at 311-12; *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*, 250 F.3d 87, 100 (2d Cir. 2001).

4. Respondents' final arrow in their quiver is the Seventh Amendment, an argument they raise here for the first time. Joined by various *amici*, respondents urge that petitioners' standard would violate the Seventh Amendment to the extent it would impose a stricter standard for pleading a securities

fraud claim than is imposed to determine whether the plaintiff's evidence of fraudulent intent would survive a motion for summary judgment or can survive a post-trial motion. Resp. Br. 40, 47. Respondents expressly rest their Seventh Amendment argument on the proposition that the passage of the Reform Act should not alter this Court's selection of a preponderance-of-the-evidence standard of proof with respect to the judicially implied private right of action under Section 10(b). *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 387-91 (1983); Resp. Br. 43.

Whether the passage of the Reform Act alters the premises underlying this Court's adoption of the preponderance standard need not be decided[2] because the Seventh Amendment surely allows a court ruling on a motion to dismiss to consider the whole complaint, treat ambiguous pleading as insufficient, and recognize that motive is pertinent to the strength of an inference of scienter. Moreover, respondents' Seventh Amendment argument is built on a false premise. Petitioners do not urge this Court to apply a higher standard for pleading a securities fraud claim than would apply at summary judgment or post-trial. In fact, the same principles discussed above that limit the range of permissible

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[2] The question whether the judicially adopted preponderance standard should be reconsidered is not "irrelevant" if this Court concludes that the Reform Act raises Seventh Amendment concerns. Resp. Br. 43. In that event, to avoid the constitutional issue, this Court could raise the judicially created proof standard if that outcome proves more consistent with Congressional intent. Acting without any congressional guidance, this Court in *Huddleston* determined that the risk of litigation error should be shared equally by both private securities fraud plaintiffs and defendants. 459 U.S. at 390-91. Congress has now made clear that the risks of error to defendants and the marketplace were too great under the prior regime, warranting enhanced standards including a "strong inference" requirement. Pet. Br. 26-30. Under these circumstances, a compelling argument could be made that a "clear and convincing" standard better captures the policies of the Reform Act than a preponderance standard.

inferences at the pleading stage should operate at the proof stage as well.[3]

For example, ambiguous allegations lacking critical, clarifying detail are not sufficient to warrant a trial. Even respondents acknowledge that, "[c]onsistent with the Seventh Amendment, procedural rules or statutes may impose pleading standards that require ... the clarification of ambiguities ... particularly where the ambiguity suggests that the pleader's case might fail as a matter of law." Resp. Br. 46 (footnotes omitted).[4] That is precisely *petitioners'* point. Congress has required "the clarification of ambiguities" for securities fraud pleadings because too many baseless claims were being filed. And, even at trial, when there is a gap in the connection between the evidence and the inferred conclusion necessary to support a judgment, a court should grant judgment as a matter of law. *Galloway* v. *United States*, 319 U.S. 372, 386-96 (1943) (directing verdict for defendant where continuous and permanent mental insanity was at issue, and plaintiff presented evidence showing insanity at outset of the relevant period and at its conclusion, but left a gap in the middle which could not be filled by inference).

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[3] Respondents and some *amici* have also argued that petitioners' standard violates the Seventh Amendment to the extent it requires a judge to evaluate the credibility of witnesses. Petitioners have never suggested that a court should assess the credibility of witnesses. It is, however, entirely appropriate for a court to demand allegations that demonstrate that there is reason to believe an anonymous confidential source has first-hand knowledge of the matters attributed to him or her, and is not simply repeating hearsay or engaging in speculation. *In re Cabletron Sys., Inc.*, 311 F.3d 11, 29-30 (1st Cir. 2002).

[4] Respondents concede that traditional common law pleading rules dismissed claims based on ambiguities without running afoul of the Seventh Amendment. Pet. Br. 39-40, 42, and Resp. Br. 46 n.49 (discussing *United States* v. *Linn*, 42 U.S. (1 How.) 104 (1843), and *Stuart* v. *United States*, 85 U.S. (18 Wall.) 84 (1873)).

Likewise, a statutory claim may not survive summary judgment based on "highly ambiguous evidence" concerning conduct that "'arise[s] in the normal course of [legitimate] business.'" *Monsanto Co.* v. *Spray-Rite Serv. Corp.*, 465 U.S. 752, 763 (1984); see also *Matsushita*, 475 U.S. at 596-97 (facts do not give rise to an inference of conspiracy when "conduct is consistent with other, equally plausible explanations"); *Cities Serv.*, 391 U.S. at 280 (same). For example, in *Matsushita*, this Court reversed a decision allowing a claim to proceed past the summary judgment stage in part because the court of appeals "did not consider whether it was as plausible to conclude that [the defendants'] price-cutting behavior was independent and non-conspiratorial." 475 U.S. at 581. And in *Cities Service*, this Court affirmed the grant of summary judgment in favor of the defendant because the evidence of participation in the alleged conspiracy was undermined by "contrary evidence" that suggested nonculpable reasons for the defendants' refusal to deal with the plaintiff that were "at least equal to the inference" of conspiracy. 391 U.S. at 277, 280. The absence of any plausible motive to engage in the allegedly unlawful conspiracy also played a significant role in this Court's decisions to preclude a trial in both cases. *Matsushita*, 475 U.S. at 596 ("[l]ack of motive bears on the range of permissible conclusions that might be drawn from ambiguous evidence"); *Cities Serv.*, 391 U.S. at 287 (because plaintiff "is unable to point to any benefits to be obtained by Cities from refusing to deal with him ... the inference of conspiracy ... does not logically follow").

A jury should, of course, be left free to draw "legitimate" and "justifiable" inferences from the record. *Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986). But, as the cases just discussed demonstrate, the range of such legitimate inferences is informed by the underlying substantive law. In those cases, an inference that did not meaningfully exclude innocent possibilities was held not to be "reasonable." Just as

this Court has narrowed the range of permissible inferences at the proof stage to advance the policies of the antitrust laws, the "strong inference" standard is, in effect, an explicit substantive direction from Congress that the courts should narrow the range of permissible inferences to advance the policies of the securities laws.

In the antitrust cases, this Court considered defendant-friendly inferences, including the absence of motive, and refused to allow ambiguous evidence to go to trial because it was concerned that if a judgment could be based on nothing more than "mistaken [jury] inferences" drawn from facts that are consistent with lawful, pro-competitive behavior, then private antitrust enforcement would chill the very conduct it was supposed to encourage. *Matsushita*, 475 U.S. at 594.[5] In securities cases, Congress concluded that allowing pleaded claims based on weak inferences to proceed to discovery was deterring the free and open disclosure of information regarding publicly traded companies, which is precisely what

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[5] Respondents emphasize that in *Matsushita* this Court was ruling based on a full factual record, and that this Court was concerned that the conduct at issue could be "pro-competitive, yet prone to be misconstrued as collusive." Resp. Br. 36, 37 n.37. Petitioners agree. And the way *Matsushita* approached the summary judgment record, by respondents' own admission, raises no Seventh Amendment concern, so approaching a pleading the same way also must raise no Seventh Amendment concern. Likewise, the fact that *Matsushita* concluded that the inference of conspiracy was not "reasonable" is no objection to petitioners' reading of the case. *Id.* at 37. Petitioners' point is that *Matsushita* narrowed the range of "reasonable" inferences to preserve the underlying policies of the antitrust laws. Contrary to respondents' suggestion, *id.* at 37-38, this Court did not read *Matsushita* differently in *Eastman Kodak Co.* v. *Image Technical Services, Inc.* 504 U.S. 451 (1992). To the contrary, *Kodak* reaffirmed that in *Matsushita* this Court was concerned that "mistaken inferences" would chill the conduct that the antitrust laws were designed to protect. *Id.* at 478. The allegations in *Kodak* did not raise that concern, so, this Court concluded, *Matsushita* was inapposite. *Id.*

the securities laws were supposed to encourage.[6] Pet. Br. 28-29. This is a substantive judgment well within the bounds of congressional authority to determine the scope of private claims under its statutes. And for the same reason that Congress would want a court to conclude that weak inferences are insufficient for pleading purposes, weak inferences should also be considered insufficient for proof purposes.

5. The abstract, semantic formulations of a "strong inference" standard take on life only through application. As one court has noted, "general standards offer little insight ... [i]t is the actual facts of ... securities fraud cases that provide the most concrete guidance as to the types of allegations required to meet" the pleading standard. *Novak*, 216 F.3d at 308. And, in many ways, it is the Seventh Circuit's approach to application that best illuminates its error. This Court's decision will best guide the lower courts to a uniform, national standard by explaining why this complaint fails.

There is a single issue here: Notebaert's scienter. As the Seventh Circuit recognized, the Reform Act makes clear that allegations of scienter must be defendant-specific. Pet. App. 21a-22a. And the Seventh Circuit ruled that the claims against both Notebaert and, derivatively, the Company could proceed based on Notebaert's alleged scienter alone.[7]

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[6] Respondents and their *amici* dispute that the problem of securities fraud strike suits, which spawned the Reform Act, remains. Resp. Br. 21-24. For present purposes it is sufficient to note that, over the past 10 years, all of which are *post*-Reform Act, 2,465 issuers have been named as defendants in securities fraud class actions out of approximately 6000 companies listed on the four major U.S. exchanges. Comm'n on the Regulation of U.S. Capital Mkts. in the 21st Century, *Report and Recommendations* 30 (Mar. 2007), *available at* www.capitalmarketscommission.com/portal/capmarkets/default.htm.

[7] In a footnote, unsupported by any citation, respondents incorrectly argue that Tellabs' scienter may be based on "knowledge on the part of many other members of Tellabs' senior management." Resp. Br. at 35

As petitioners demonstrated in their opening brief, Pet. Br. 43-50, the Seventh Circuit identified the specific allegations that it believed supported a "strong inference" of scienter. Petitioners demonstrated that the Seventh Circuit's analysis ignored critical facts, including public announcements downgrading expectations in the midst of an alleged fraud inflating those expectations; ignored the absence of any plausible motive for Notebaert to engage in fraud; and relied on strategically ambiguous allegations regarding when Notebaert supposedly learned of weakening demand for Tellabs' products, whether Notebaert knew of any illegitimate channel stuffing, and whether Notebaert was aware of problems in the development and shipping of the TITAN 6500 during the class period.

Respondents disregard the Seventh Circuit's analysis and its express reliance on certain specified allegations. Indeed, they almost entirely sidestep their obligation to point to facts in their complaint which establish *Notebaert's* scienter. Instead, respondents indiscriminately refer to a broad array of allegations pertaining to a variety of defendants (against whom Section 10(b) claims were dismissed without appeal), Resp. Br. 2-12, and some of which even the Seventh Circuit explicitly acknowledged could not support a strong inference of scienter. For example, respondents repeat allegations regarding supposedly fictitious sales and backdated orders, *id.* at 10, 12, but the Seventh Circuit concluded that those allegations were insufficiently particularized to satisfy the Reform Act's standard, Pet. App. 13a. In addition,

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n.35. As noted in the text, the Seventh Circuit rejected this very argument, and there is no basis for this Court to reach it given that it has not been briefed by either party. In any event, respondents are wrong. Under both the common law and Section 10(b) law before and after the Reform Act, "a principal may not be subject to liability for fraud if one agent makes a statement, believing it to be true, while another agent knows facts that falsify the other agent's statement." Restatement (Third) of Agency § 5.03 cmt. d(2) (2006); *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366-67 (5th Cir. 2004) (collecting cases).

respondents repeat allegations concerning alleged weakening of demand for Tellabs' products dating back into the middle of 2000, *e.g.*, Resp. Br. 2, even though the Seventh Circuit concluded that "it was not until March 2001 that the TITAN 5500's declining status was obvious." Pet. App. 24a.

It should be no surprise that respondents fail to address the specific allegations relied upon by the Seventh Circuit, and instead adopt a kitchen-sink approach. When this Court pushes past respondents' distractions,[8] and focuses on the facts purporting to support an inference of scienter as to Notebaert, the proper resolution of this case becomes straightforward. Respondents say nothing to dispute that their pleading is ambiguous in critical respects, either as to channel stuffing, the timing of reports regarding weakening demand, or the nature of Notebaert's alleged knowledge of unspecified "problems" with the TITAN 6500. They instead resort to claiming the benefit of ambiguity. Resp. Br. 33-35. It is critically important that this Court make clear that allegations of this sort are insufficient to create a "strong inference" under any formulation.

Respondents' effort to explain why they believe they have adequately alleged motive also fails, and is an exemplar of the type of "weak" inference that should not be credited because

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[8] Two of respondents' distractions warrant a brief response. First, respondents claim that petitioners have no basis to assert that Notebaert's statement regarding "end user demand for services," JA 34, refers to customers of Tellabs' customers. Resp. Br. 7, n.6. But Notebaert says in the very next sentence that Tellabs' products "help[] our carrier customers meet this demand," JA 34, which makes indisputably clear that he is referring to the demand of Tellabs' customers.

Second, respondents also confuse matters in seeking to downplay the undisputed fact that Tellabs' revenues increased by 21% in the first quarter of 2001 over the same quarter in the previous year. Pet. Br. 47. Respondents present data for the same periods with respect to net earnings, not revenue. And respondents present revenue figures for different quarters, not the same quarters over consecutive years. Resp. Br. 9 n.10.

it can be drawn in any circumstance. Respondents assert that Notebaert's "livelihood and business reputation depended on his Company's success." Resp. Br. 36 n.36. Putting aside that no such claim is made in the complaint, this is precisely the kind of universally present motive that courts refuse to treat as adequate. "[I]f scienter could be pleaded on that basis alone, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions." *Acito*, 47 F.3d at 54. Even putting that problem aside, respondents' claim that Notebaert's job and reputation gave him some incentive merely to delay revealing the "true facts" regarding Tellabs' performance for a limited period of time makes no sense. There is no plausible motive when all that is alleged is a "short respite from an inevitable day of reckoning." *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994).

Respondents also try to counter certain of the circumstances that significantly undermine respondents' claim of scienter. Respondents argue that the statements modifying Tellabs' guidance downward during the class period were "incomplete and deceptive." Resp. Br. 35. That they were "incomplete" is just another way of saying that Tellabs eventually did not meet even those modified projections. That they were "deceptive" is an unsupported conclusion about Notebaert's mental state at the time he announced those revisions. In fact, as petitioners pointed out, Notebaert's mid-class period revisions were actually *greater* than the amounts the complaint alleges were projected in the various reports of weakening demand, which form the primary basis for the claim of Notebaert's scienter. Pet. Br. 47-48.

CONCLUSION

The decision of the Seventh Circuit should be reversed.

Respectfully submitted,

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